

Chapter 2: Financial Statements & Operations

To analyze a liquor store's operations a close look must be taken at the day to day operations as well as examining the liquor store's financial history. Usually more emphasis is placed on financial ratio analysis. However, financial statements offer only figures. Many times more insight can be gained by simply walking through a liquor store.

A Liquor Store Operator's Business Strategy

For most liquor store operators growth has been primarily through innovation and price cuts. As a result, most operators try to match their target market's tastes as closely as possible to gain maximum foot traffic. For example, a liquor store in a blue collar area of Detroit, MI may not need to provide as much customer service as a liquor store in Greenwich, CT where many of the patrons are the wealthiest individuals in America.

Although the types of liquor stores vary by state, due to government regulations, liquor stores are popular throughout the nation. In some states, operators of liquor stores may be the sole retailers of certain types of alcoholic beverages, which reduces the degree of competition from parallel retailers. However, in states such as California, retailers compete directly with grocery stores, convenience stores, wholesalers, online retailers, and other liquor stores, as well as bars and restaurants, all of whom can retail the same types of alcoholic beverages.

In the face of competition from such a large variety of venues, some operators choose to compete on a discount level in the United States. These operators maintain their discount operations in the U.S. to serve patrons who are willing to sacrifice time, convenience and customer service to get the cheapest possible price on their alcoholic beverages. Such stores typically have a similar product mix to a standard liquor store but with a slight bias towards lower end products.

Discount Operations

Also, the liquor store industry is moving towards consolidating smaller liquor stores into larger chains or replacing them completely with large wholesaler type stores in states which allow the practice. Chains and large stores enable an operator to present a wider variety of alcoholic beverages appealing to

Consolidation of Smaller Stores

several segments of the market, while providing lower prices due to their negotiating power with local distributors.

Some operators have generated additional revenue through in-store promotions for certain suppliers as well as providing spirits tastings in states which permit this practice. However, a typical liquor store operator does not rely as much on advertising as it does on the store's location. Stores with good locations rely heavily on the ability of the surrounding retailers and attractions to bring in new patrons and increase sales.

Operating Revenue From Liquor Stores

Liquor Store's Revenue Sources

Liquor stores generate their revenue primarily from the sale of alcoholic beverages, tobacco products and miscellaneous food item sales. A list of the different sources of revenue and expenses from the operation of a liquor store along with a typical range calculated as a percentage of total sales can be seen in Table 2-1 on page 41.

Product Sales

Alcoholic beverage sales are an operator's largest revenue source, typically representing up to 90% of total revenues. Most operators have devoted considerable management effort to increasing alcoholic sales and improving the gross profit margins by promoting higher-margin products such as high-end vodka and related spirits.

Advertising Revenue

Liquor stores have the ability to provide in-store advertising for suppliers of alcoholic beverages in order to promote a certain product line (depending on state). Revenues are primarily contingent upon the success of the sales efforts, as well as upon the location of the store and foot traffic which the store receives.

Other Revenue Streams

Operators actively engage in efforts to develop revenue streams in addition to alcoholic beverages, tobacco and food item sales. Some operators have offered spirits tastings, custom wine cellar designing services, or even delivery services to gain additional revenues. However, it must be noted that income from wine tastings are typically not shown as revenue on the books and usually goes into the owner's back pocket (unreported "skim"). Lastly, lottery tickets have recently become a stable revenue source.

Operating Expenses From Liquor Stores

Operating Costs

Primary operating costs include:

1. Rent,
2. Costs of goods sold,
3. Salaries, wages and compensation of staff

Rent costs vary depending on the location of the facility, but they are typically proportional to the median cost of housing in the immediate market. However, in general, larger grossing liquor stores benefit from higher volume and sales per square foot. Thus, as a percentage of sales, rent is typically 2.5 - 3.5% of annual revenue annually for liquor stores with revenues over \$750,000. Under that figure, rent begins comprising a larger portion of revenues, with a range of 5.5 - 6.5%.

Rent

Product costs include direct product costs and promotional expenses. Costs remain similar among stores with sales ranging from \$100,000 to over a \$1 million, as a percentage of sales. Larger wholesaler type stores can possibly reduce the industry average of cost of goods sold to 78%¹ depending on the volume and state they are operating within; however, many states regulate the quantity discounts to protect smaller liquor stores.

Cost of Products Sold

Table 2-1: Revenue & Expense Summary (As a % of Sales)

Income/Expense Item	Range (Beer, Wine, and Liquor Stores)
Revenue	percentage of sales
Alcohol Sales	85%-90%
Tobacco Products	5%-8%
Grocery & Other Food Items	2%-6%
Immediate Consumption Food Items	0.1% - 1%
Expenses	percentage of sales
Cost of Goods Sold	60%-80%
Operating Expenses	15% - 25%
Other Expenses	3% - 8%
Depreciation and Amortization	variable

Source: U.S. Census Bureau, 2002 Economic Census, RMA, Actual Financial Statements.

Most liquor stores are managed by one full-time manager and a few part-time employees. The part-time employees are usually paid minimum wage; however, in certain areas with low unemployment, it might be beneficial to pay above minimum wage to garner better employees. It should be noted that stores which focus on customer service will spend more time training employees than regular stores and will have to attract better employees through higher wages to reduce turnover.

Personnel Expense

Cost of goods sold, and salaries and wages vary directly with changes in revenues. These expenses have historically represented approximately 80-90% of all liquor store costs and approximately 70-80% of revenues. Cost of products sold tend to move proportionately with revenues while salaries and wages remain fixed costs. Operators typically purchase supplies to replace units sold.

Summary

1. U.S. Census Bureau, 2002 Economic Census, RMA, Actual Financial Statements

Liquidity and Capital Resources

Working Capital

An operator's revenues are collected in cash and through credit card transactions. Liquor stores generally pay for the alcoholic beverages up front or through a payable account. Since days in inventory for the industry are close to two months, working capital tends to be around 20% of sales. Working capital, however, should be compared to previous periods for the same business, as an increase in working capital over the years indicates that the store is not operating efficiently and is most likely tying up its resources in inventory.

Also, larger stores can sometimes benefit from better relationships with distributors, so that they can leave items purchased on account unpaid for longer periods of times. This lowers their working capital position but frees up cash to be utilized for other business expenditures.

Review of Liquor Store's Financial Position

The degree of competition and financial ratios are related to each other. A financial overview of the liquor store in comparison to its industry can usually be done by looking at four different categories of ratios:

- Activity ratios
- Liquidity ratios
- Long term debt and solvency ratios
- Profitability ratios

These ratios should be compared to those of similar businesses within the industry or SIC (Standard Industrial Classification) code.

These ratios are calculated by either averaging the figures for two different years, or by taking only one year's figures. The difference between these two calculations can be seen in the table below.

Table 2-2: Example of Financial Ratio Differences for Two and One Year Averages

Ratio	Formula (2 Year Average)	Formula (1 Year)
Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Average Inventory for Two Years}}$ $\frac{216,727}{94,000 + 97,019/2} = 2.27$	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$ $\frac{216,727}{94,000} = 2.3$

Figures taken from Table 2-3 on page 43 and Table 2-4 on page 44

When calculating all of these ratios, the resulting figures should be taken with "a grain of salt," since these figures are simply a snap shot in time. The

existing health of the operations of a liquor store can be completely different from what the ratios may indicate. As they say “historical results may not be indicative of future returns.” Furthermore, accrual accounting tends to smooth these figures and their trends.

Our subject liquor store’s balance sheet and income statement can be seen in Table 2-3 on page 43, and Table 2-4 on page 44, as a reference for discussion. **It must be noted that this example is on a lease with equipment and machinery being leasehold improvements.**

Table 2-3: Sample Balance Sheet of a Liquor Store

	2006	%	2005	%
Assets				
Current Assets				
Cash & Equivalents	\$5,384	1.9%	\$9,854	3.2%
Accounts Receivable	1,200	0.4%	2,015	0.7%
Inventory	94,000	33.2%	97,019	31.5%
Total Current Assets	100,584	35.5%	108,888	35.4%
Gross Fixed Assets				
Equipment & Machinery	107,000	37.8%	111,500	36.2%
Total Gross Fixed Assets	107,000	37.8%	111,500	36.2%
Less: Accumulated Depreciation	(59,250)	-20.9%	(47,400)	-15.4%
Net Fixed Assets	47,750	16.9%	64,100	20.8%
Other Assets*	135,000	47.6%	135,000	43.8%
Total Assets	\$283,334	100.0%	\$307,988	100.0%
Liabilities and Equity				
Current Liabilities				
Accounts Payable Trade	47,040	16.6%	60,800	19.7%
Current Long Term Debt	5,376	1.9%	5,435	1.8%
Total Current Liabilities	52,416	18.5%	66,235	21.5%
Long Term Debt	67,200	23.7%	72,635	23.6%
Total Liabilities	119,616	42.2%	138,870	45.1%
Shareholders' Equity	163,718	57.8%	169,118	54.9%
Total Liabilities and Equity	\$283,334	100.0%	\$307,988	100.0%
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Working Capital	\$48,168	17.0%	\$42,653	13.8%
Debt Free Working Capital	\$53,544	18.9%	\$48,088	15.6%

*see “Quota System” on page 44.

The liquor store represented in Table 2-3 and Table 2-4 represents a standard liquor store located in Southern California. This store has one part-time employee and a full-time manager. It operates Monday through Thursday from 10 AM through 10 PM and until midnight on the weekends and holidays. This store has been profitable over the past two years.